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Questions concerning profit recognition on sales of real estate : proposal to to Financial Accounting Standards Board to clarify AICPA Industry Accounting Guide on Accounting for Profit Recognition on Sales of Real Estate; Statement of position 75-6;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position on

75-6

Questions Concerning Profit Recognition on Sales of Real Estate

December 29, 1975

Proposal to Financial Accounting Standards Board to Clarify AICPA Industry Accounting Guide on Accounting for Profit Recognition on Sales of Real Estate

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

The American Institute of Certified Public Accountants has issued a series of industry-oriented Audit Guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of Accounting Guides that present recommendations on accounting principles. Based on experience in the application of these Guides, AICPA Task Forces may from time to time conclude that it is desirable to change a Guide. A Statement of Position is used to revise or clarify certain of the recommendations in the Guide to which it relates. A Statement of Position represents the considered judgment of the responsible AICPA Task Force.

To the extent that a Statement of Position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the Audit Guide to which it relates. As to such matters, members should be aware that they may be called upon to justify departures from the recommendations of the Task Force.

To the extent that a Statement of Position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the Task Force are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the Task Force believes would be in the public interest.

AICPA

American Institute of Certified Public Accountants
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 29, 1975

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position has been prepared by the Accounting Standards Task Force on Real Estate Accounting to clarify the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate.

Numerous questions have arisen in practice with respect to the application of the general principles and specific conclusions set forth in the Guide. Questions as to the applicability of the Guide to specific transactions and to companies other than real estate companies have also been raised. The Task Force has identified certain key questions and has recommended appropriate responses to them in this Statement of Position.

Members of the Task Force will be glad to meet with you or your representatives to discuss this proposal. The Task Force would also appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Melvin Penner

MELVIN PENNER
Chairman
Accounting Standards Task Force
on Real Estate Accounting

cc: Securities and Exchange Commission

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Note: The paragraph and exhibit references above are to appropriate sections of the AICPA Industry Accounting Guide, Profit Recognition on Sales of Real Estate, hereinafter referred to as the "Guide."

BUYER'S INVESTMENT IN PURCHASED PROPERTY

Funds Provided (Loaned) by Seller

Question:

With respect to Paragraph 22 of the Guide, what is the effect on the test of the adequacy of the down payment in a sale of real estate if the seller has made or will be making loans to the buyer builder/developer for acquisition, construction or development purposes? What is the effect of the existence of a permanent loan commitment by an independent third party?

Answer:

Under Paragraph 22, any funds that have been loaned or will be loaned, directly or indirectly, to the buyer by the seller must first be deducted from the down payment in determining whether the down payment test has been met. Paragraph 22 does not require that the funds loaned by the seller be specifically identified with the funds comprising the down payment. As an example, if "A" sells unimproved land to "B" for $100,000, receives a down payment of $50,000 in cash, and plans to loan "B" $35,000 at some future date for installation of water and sewer lines, the down payment test has not been met. ($50,000 - $35,000 = $15,000 ÷ $100,000 = 15%; fails test as at least 20% is required.)

Funds provided directly or indirectly by the seller include loan guarantees, collateral provided by the seller, and any other situation where the seller is subject to loss as a result of funds loaned to the buyer.

Existence of a permanent loan commitment by an independent third party for replacement of the construction or development loan made by the seller does not eliminate the need to deduct the seller's loan from the down payment under Paragraph 22. The Guide did not intend that consideration be given to such commitments and construction or development loans by the seller to the buyer must be deducted from the down payment whether or not a permanent loan commitment exists.

Acceptable Letters of Credit

Question:

Paragraph 22 of the Guide requires that a buyer's down payment be composed of cash or notes supported by irrevocable letters of credit from an established lending institution. What constitutes an "established lending institution?" If the letters of credit are obtained subsequent to the period in which the transaction takes place but prior to the issuance of the financial statements, is it appropriate to include them for purposes of determining compliance with the down payment criteria in the earlier period?

Answer:

An "established lending institution" refers to institutions, usually commercial banks, that issue letters of credit in the normal course of business.

Buyer's notes, unless and until supported by irrevocable letters of credit covering the period of the notes, do not constitute cash equivalency (see Paragraph 15) in a real estate transaction. Accordingly, the down payment criteria are not met for accounting purposes until the period in which letters of credit are obtained.

Cumulative Application of Tests when Recognition of Sale is Delayed

Question:

Paragraph 27 of the Guide states that the "tests of adequacy of a buyer's initial and continuing investment...should be applied cumulatively--at the closing date and annually afterwards." What date should be used for the purpose of these tests when the transaction is not recorded as a sale for accounting purposes on the closing date and the proceeds are accounted for as a deposit?

Answer:

The Guide indicates that under certain conditions the effective date of the sale for accounting purposes is required to be deferred (see Paragraphs 9, 34, 35, 42, 45 and 54). When a transaction is recorded under the deposit method, the date from which the cumulative test would begin to apply would be delayed until the sale is recorded for accounting purposes.

Applicability of the Alternative 115% Test for Down Payment

Question:

Does the alternative 115% test for down payment under Paragraph 20 of the Guide apply if (a) the seller takes a receivable, collateralized by a first mortgage on the property sold, for the entire difference between the sales value and the down payment, or (b) if the buyer assumes, or takes the property subject to, a primary loan that is not a newly placed permanent loan for a portion of the difference between sales value and the down payment?

Answer:

No. The 115% test for down payment in Paragraph 20 does not apply if a newly placed permanent loan or firm loan commitment from an independent lender is not involved.

Down Payment Requirements on
Single Family Residential Housing

Question:

Footnote (b) to Exhibit A (minimum down payment requirement) calls for a higher down payment on sales of single family residential property if collectibility of the remaining portion of the sales price cannot be supported by reliable evidence of collection experience. Do the provisions of footnote (b) apply when independent first mortgage financing is utilized?

Answer:

No. The provisions of footnote (b) are applicable when independent first mortgage financing is not utilized and the seller takes a receivable from the buyer for the difference between the sales value and the down payment. When independent first mortgage financing is utilized, the minimum down payment on sales of single family residential property should be determined in accordance with Paragraph 20 of the Guide.

SELLER'S CONTINUED INVOLVEMENT WITH PROPERTY SOLD

Time of Sale Considerations

Question:

Are Paragraphs 47-48 and 60 of the Guide in conflict with the closing requirements in Paragraph 14 of the Guide? Paragraphs 47-48 and 60 permit income recognition during a development or construction phase assuming all other conditions of the Guide are met. On the other hand, Paragraph 14 includes as a prerequisite to income recognition the criterion that "...all conditions precedent to closing have been performed." One major condition precedent to closing on such properties as buildings, condominiums, etc., is that the structure be ready or certified for occupancy. Which of these paragraphs prevails? If an exception to Paragraph 14 is intended with respect to completion, then are exceptions intended with respect to any other requirements of Paragraph 14?

Answer:

Because of the length of the construction period of office buildings, condominiums (especially high rise), shopping centers and similar structures (excluding single family homes), the Guide was written to permit income recognition during the process of construction even though the fact of completion is usually a "condition precedent," and thus this exception to Paragraph 14 is an exception to this condition only.

Calculation of Safety Factor

Question:

In applying Exhibit C, Paragraph 55 of the Guide states "that estimated rent receipts should be reduced by a safety factor of 33-1/3% unless signed lease agreements have been obtained to support a projection higher than the rental level thus computed." Should the 33-1/3% reduction be applied to the total estimated future rent receipts (including the amount resulting from signed lease agreements) or only to the estimated future rent receipts which are not yet subject to signed lease agreements?

Answer:

The 33-1/3% reduction should be applied to the total estimated future rent receipts for each period unless the amount so computed is less than the actual amount of rent receipts resulting from signed lease agreements. In this event, the actual amount would be substituted for the computed amount.

As a example, "A" sells an office building under development to "B" together with an agreement to support operations of property for a period of three years. The projected annual rent roll is $1,000,000, of which $350,000 is supported by signed lease agreements. The projected rental income for the first year of operation of the office building is $600,000, the second year $750,000 and the third year $1,000,000. At the time of sale, the amounts includible in the Exhibit C calculation would be computed as follows:

Year	Projected Rental Income	Safety Factor (33-1/3%)	Adjusted Projected Rental Income
1	$ 600,000	$200,000	$400,000
2	750,000	250,000	500,000
3	1,000,000	333,333	666,667

In the example, if at the time of sale there were signed lease agreements in the amount of $450,000, then the $450,000 would be used in year 1 since it is greater than the adjusted projected rental income. The adjusted projected rental income for years 2 and 3 would remain $500,000 and $666,667, respectively.

Sales of Condominiums

Question:

Paragraph 60 of the Guide with respect to sales of condominium units states that "profit should not be recognized...unless construction is beyond a preliminary stage, the buyer is committed to the extent of being unable to require a refund, sufficient units have already been sold to assure that the property will not revert to rental property, and aggregate sales proceeds can be estimated reasonably." What do each of the above criteria for profit recognition mean?

Answer:

"Construction Is Beyond a Preliminary Stage"

Actual construction of buildings usually must be preceded by engineering and design work, execution of construction contracts, site clearance and preparation, excavation and completion of the building foundation. Ordinarily, if any one of these required phases is incomplete, the work is not beyond a preliminary stage.

"The Buyer Is Committed to the Extent of Being Unable to Require a Refund"

The buyer cannot have the right under the terms of the agreement or by law to receive a refund, except for nondelivery of the unit. Examples where a sales contract may not be binding and therefore voidable may include but are not limited to the following:

- Certain states require a minimum status of completion of the project.
- Certain states require that a "Declaration of Condominium" be filed. (In some states, however, the filing of the declaration is a routine matter and the lack of such filing may not make the sales contract voidable.)
- Some sales contracts include a provision that permanent financing at an acceptable cost must be available to the buyer at the time of closing.
- Certain condominium units must be registered with either the Office of Interstate Land Sales Registration of the Department of Housing and Urban Development or the Securities and Exchange Commission.

"Sufficient Units Have Already Been Sold to Assure that the Property Will Not Revert to Rental Property"

In determining whether or not this condition has been met, the following should be considered:

- Economic conditions.
- Developer's history.

- State laws may require that a specified percent of units be sold.
- Sales contract may provide buyer with right of rescission until a specified percent of units are sold.
- Seller may retain right to convert to rental basis.
- Construction loans may require that a specified percent of units be sold before the lender will release any units.
- End loan financing commitments may provide that a specified percent of units be sold before closing of any sale.

The Guide intended to preclude recognition of profit on sales of condominium units which can later be rescinded because the entire property reverts to a rental project. Technically, this provision of the Guide may be satisfied when the number of units sold meets the requirements of the state law (or relevant jurisdiction), the condominium contract and the financing agreement, so that such sales are not legally voidable either by the buyer or the seller. Nevertheless, there is a presumption that at least 50% of the individual units should be sold before any profit is recognized on the percentage of completion method. The reason for this presumption is that profit attributed to units sold may not be subject to reliable estimates until a substantial number of units are sold, because of uncertainties concerning either the ultimate number and sales value of units to be sold (see below) or the costs to be incurred.

"Aggregate Sales Proceeds Can Be Reasonably Estimated"

Consideration should be given to sales volume, trends of unit prices, developer's experience, geographical location and environmental factors. Sometimes certain units in a condominium project are difficult to sell, indicating that the pricing structure may not reflect realizable sales value. For example, certain units may have been designed in a manner that does not reflect changes in market demand, or certain units may not be as desirable as others because of location or aesthetic factors. In these cases, consideration should be given to the possibility that some of the remaining units may not be sold or may have to be sold at substantially reduced prices.

APPLICABILITY OF THE GUIDE

Applicability to Companies Other Than Real Estate Companies

Question:

Paragraph 3 states that the Guide was prepared to appraise accounting practices in the real estate industry. Are the principles in the Guide applicable to manufacturing, distribution and other companies which are not real estate companies?

Answer:

Yes. The Guide was meant to apply to all sales of real estate, except retail lot sales covered by the AICPA Industry Accounting Guide, Accounting for Retail Land Sales, without regard to the nature of the seller's business.

Sale of Corporate Stock

Question:

The Guide primarily covers the timing of profit recognition on real estate sales. Does the Guide apply to the sale of corporate stock of a company with substantial real estate?

Answer:

If the sale is in economic substance a sale of real estate, provisions of the Guide would apply.

Sale of Partnership Interests

Question:

The Guide contains provisions for the timing of profit recognition if a person sells to a limited partnership in which the seller is the general partner. Is the Guide applicable if a person forms a partnership, arranges for the partnership to acquire the property directly from third parties, and sells a portion of his interest in the partnership to persons who then become limited partners?

Answer:

The Guide is applicable. In particular see Paragraphs 57 to 59 of the Guide with respect to partial sales.

Sale of an Option

Question:

The Guide primarily covers the timing of profit recognition on real estate sales. Does the Guide apply to the sale of options to purchase real estate?

<u>Answer:</u>

Yes. Sale of such an option is a sale of an interest in real estate and, accordingly, the principles in the Guide apply.

For purposes of evaluating the buyer's commitment when an option is sold by an option holder, the initial and continuing investment by the buyer of the option (which would exclude amounts which are subject to refund by the seller) should be related to the total of the exercise price of the option and the sales price of the option. For example, if the option is sold for $150,000, ($50,000 cash and a $100,000 note) and the exercise price is $500,000, the sales value against which the buyer's down payment and continuing investment is measured is $650,000. If the buyer's investment is inadequate, income may be recorded on the cost recovery method to the extent non-refundable cash proceeds exceed the seller's cost of the option.

Proceeds from the issuance of a real estate option by a property owner should be accounted for as a deposit as set forth under Paragraph 35 of the Guide. It is not appropriate to recognize income before the option either expires or is exercised because the sale of the option cannot be evaluated independently from the sale of the real estate to which the option relates. If the option is exercised, cash proceeds from the issuance of the option should be accounted for as a down payment and included in sales value.

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